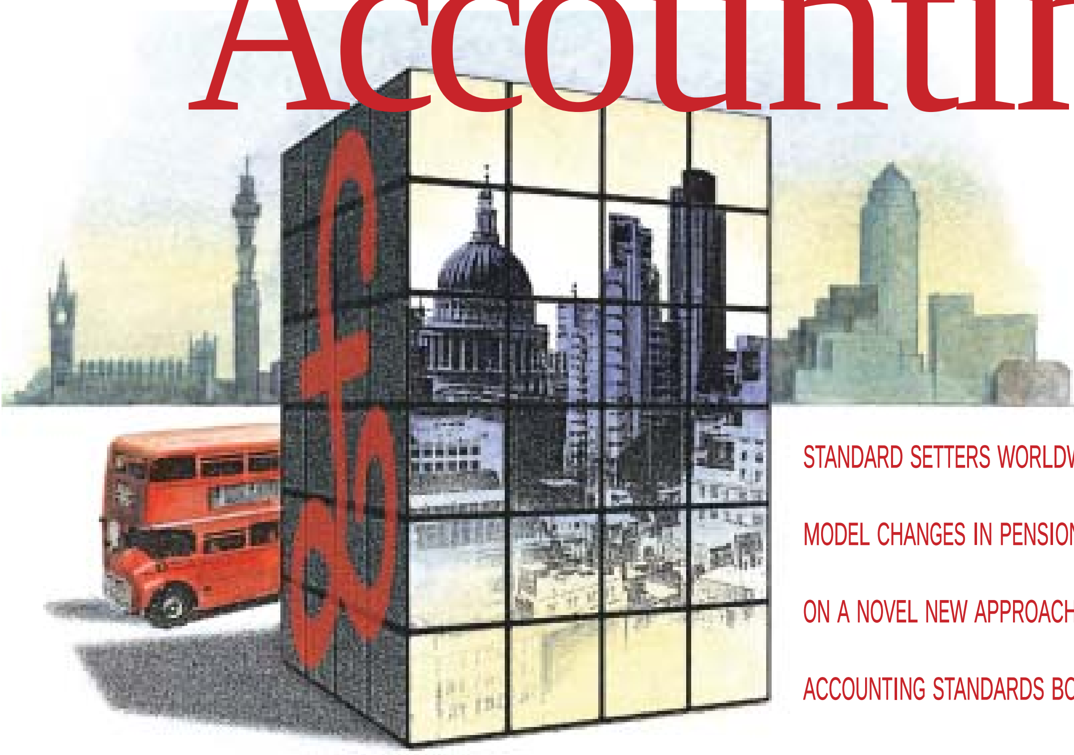
Opinion

Provocative Pension Accounting



STANDARD SETTERS WORLDWIDE SHOULD MODEL CHANGES IN PENSION ACCOUNTING ON A NOVEL NEW APPROACH THE U.K.'S ACCOUNTING STANDARDS BOARD HAS TAKEN.

BY OLE-KRISTIAN HOPE, CMA, CFM, CPA

As U.S. defined-benefit pension plans have lost money, many corporate plan sponsors have reported gains. They've done so completely in accord with current U.S. accounting standards. But a bold new U.K. standard starkly departs from—and greatly improves—complicated U.S. pension accounting.

The U.K.'s Financial Reporting Standard (FRS) No. 17, "Retirement Benefits," issued by the Accounting Standards Board of the U.K. in November 2000 and amended in November 2002, improves both the balance sheet and income statement treatment of retirement obligations. It also enhances earnings quality, classification of pension expense components, and definition of a balance sheet liability. All of this will potentially improve both the transparency of a company's economic obligations and analysts' ability to predict future earnings and cash flows. I think the U.S. Financial Accounting Standards Board (FASB) should take a cue from its U.K. counterpart and make similar changes to pension accounting.

DECEPTIVE ACCOUNTING

Here's how deceptive U.S. pension accounting can be.

ILLUSTRATION: SIMON FELL/ARTVILLE

General Electric reported a negative pension expense (i.e., pension income) of $2.1 billion in its fiscal-year 2001. During this period the company recorded an expected gain of $4.3 billion on plan assets, but the plan actually lost $2.9 billion. Because of the convoluted nature of pension accounting, this loss wasn't recognized. Instead, it was accumulated outside the financial statements. In addition, GE's pension expense was reduced by a "net actuarial gain" of almost $1 billion. Had GE based pension cost on actual rather than expected return on plan assets, and not included the actuarial gain, the company would have recorded an expense of $5.1 billion. This $7.2 billion increase in expense translates into a 42% decrease in GE's overall income before taxes.

But GE is far from the only U.S. company that reports pension income when its pension plan is actually losing money. Plunging stock prices help make this a relatively common phenomenon. In addition, many firms are showing pension liabilities on their balance sheets that bear very little resemblance to their economic liability for retirement benefits.

GE and other companies aren't trying to fool anyone. In fact, they're just following the rules as laid out in the FASB's Statement of Financial Accounting Standards (SFAS) No. 87, "Employers' Accounting for Pensions" (and SFAS No. 132, "Employers' Disclosures about Pensions and Other Postretirement Benefits—an amendment of FASB Statements No. 87, 88, and 106").

SFAS No. 87 is arguably the most complicated financial reporting standard ever issued. It is designed to avoid volatility in pension expense, which means that the accounting impacts of economic events are smoothed. This is accomplished through a series of smoothing mechanisms—such as not immediately recognizing the difference between actual and expected returns on plan assets and changes in actuarial assumptions. All six components of pension expense—service cost, interest cost, expected return on plan assets, recognized gains or losses, amortization of unrecognized transition asset or obligation, and recognized prior service cost—are lumped together in compensation expense. Furthermore, the pension liability (or asset) shown on the balance sheet doesn't necessarily reflect the economic obligation the company has; rather, it results from the cumulative difference between the company's contribution to the plan and the recognized pension expense. Consequently, pension assets and liabilities most likely don't meet the definitions of assets and liabilities detailed in Statement of Financial Accounting Concepts No. 6, "Elements of Financial Statements."

Note that these issues aren't limited to U.S. companies. In 2000, for example, Canadian firms adopted Section 3461 of the *Canadian Institute of Chartered Accountants' Handbook*, which is similar to SFAS No. 87. So many Canadian firms are in a similar situation because they, too, have experienced losses on their pension assets, and their accounting can produce pension gains even when there are economic losses.

THE U.K.'S NOVEL APPROACH

Enter the U.K.'s accounting standard FRS No. 17. It is altogether different.

FRS No. 17 is effective for accounting periods ending on or after June 23, 2003. Disclosures—but not changes in measurement or recognition—were required for 2002. Here are its main requirements:

1. Balance sheet. The amount by which the pension plan is underfunded (i.e., projected benefit obligation exceeding the market value of the plan assets) must be recognized in full on the balance sheet of the sponsoring firm. A pension surplus is also recognized, but only to the extent it can be recovered.

2. Income statement. The changes in the surplus or deficit are analyzed into:

- **a.** Service cost (including past service cost, if any) is included in operating income;
- **b.** Interest cost and expected return on plan assets are recognized as other financing costs; and
- **c.** The remaining elements of pension cost (actuarial gains and losses) are recognized in other comprehensive income called "the statement of total recognized gains and losses."

This is an interesting and novel approach to pension accounting that departs starkly from current U.S. practice as well as the U.K. standard it replaces, the Statement of Standard Accounting Practice (SSAP) No. 24, "Accounting for Pension Costs."

First, the new standard puts the economic status of the plan on the sponsoring firm's balance sheet. This raises interesting issues in accounting theory. The basic issue is whether the pension plan should be consolidated with the financial statements of the sponsoring firm. Under defined-benefit plans, employers bear the risk of investment performance, suggesting that the sponsoring firm should show a liability reflecting this risk. Also, the issue is what the sponsoring firm really is liable for. Under SFAS No. 87, the so-called "minimum liability" corresponds to a legal liability definition: The liability is accrued in accordance with the explicit terms of the plan.

Effectively, SFAS No. 87 treats the pension plan as a separate entity.

An alternative view of the pension liability, explicitly or implicitly endorsed by U.K. standard setters, is that the pension contract is a long-term relationship between employer and employee and that the sponsoring firm will meet the promised future benefit. Under this view, the pension plan is seen as integral to the firm and not as an independent entity. This view is also consistent with that of many financial analysts who advocate adjusting the balance sheet of the sponsoring firms for the market value of the plan assets and the economic liability (usually interpreted as the projected benefit obligation) to the retirees.

Equally interesting is the approach FRS No. 17 takes to the income statement treatment of pension expense. The issues here are related to whether (1) the smoothing of pension expense is useful to users of financial statements, (2) pension expense belongs in operating income, and (3) the components of pension expense should be classified in ways that would aid analysts in forecasting future earnings and cash flows. Regarding the first issue, textbooks of financial statement analysis often cover how to "unravel the smoothing and lagging provisions" inherent in SFAS No. 87. Many—but not all—analysts argue that the entire pension cost does not belong in operating income. According to these analysts, only service cost should be included in operating income because service cost represents the present value of the increased pension payout arising from current services. Interest cost is viewed as any other financing cost because it arises from the passage of time. And the return on plan assets can be viewed as similar to return on investment securities. The U.K. standard follows this logic very closely in separating operating income from nonoperating items. This approach is consistent with Standard & Poor's relatively new definition of "core earnings," which excludes pension gains.

Furthermore, analysts often focus on some measure of income from continuing operations to assist them in assessing sustainable earnings—what future earnings are likely to look like. Service cost, interest cost, and expected return on plan assets are relatively permanent components of earnings that are likely to persist into the future. Other components, such as the deferred portion of the current period's actual return on plan assets, are likely to be more transitory. Therefore, separating these different components of pension expense may be useful for forecasting. In the U.S., this information is found in the notes only.

To illustrate, under FRS No. 17, GE's pension expense would have been reported as follows (in millions of dollars):

OPERATING EXPENSES:	
Service cost of pensions (including prior service cost)	1,128
OTHER FINANCING EXPENSES (INCOME):	
Pension interest cost	2,065
Expected return on pension plan assets	(4,327)
OTHER COMPREHENSIVE INCOME:	
Difference between actual and expected return on pension plan assets (reduces comprehensive income)	7,203
Net actuarial gain recognized	(961)

This illustration shows that, on the income statement, FRS No.17 separates out the operating component of pension cost (i.e., service cost) from the financing components (expected return) and the other components of pension expense. This should assist users of financial statements in forecasting future pension costs and cash flows. On its balance sheet, GE would report as an asset the pension plan overfunding (i.e., the excess of plan assets over projected benefit obligation) of 14,583 instead of a net asset of 12,415.

A LEAD TO FOLLOW

It's unclear what the future will hold for pension accounting in the U.K. because, as an EU member, the U.K. has committed itself to requiring all U.K. companies to adopt International Accounting Standards, promulgated by the International Accounting Standards Board (IASB), by 2005. Currently, International Accounting Standard (IAS) No. 19, "Post-Employment Benefits Including Pensions," roughly parallels SFAS No. 87, but the IASB is now considering changes to pension accounting rules.

Still, it will be interesting to see how U.K. managers and analysts react to the new requirements. As with many other accounting issues, executives worry about increasing volatility in reported earnings. But I believe the U.K. standard setters have done well with logical improvements to both the balance sheet and income statement treatment of retirement obligations. Now other standard setters should follow. ■

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